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SUBJECT: 06-07 BUDGET USES PETROLEUM FUND TO TARGET POVERTY

REF: A) 2005 DILI 406, B) DILI 161

DILI 00000474 001.2 OF 003

11. Summary: Following Parliamentary approval last month, the Government of East Timor (GOET) FY 2006-2007 budget went into effect in early September, two months after the beginning of the fiscal year on July 1. At \$315.9 million this budget reflects an increase of more than 100 percent over the previous year and is primarily funded by East Timor's Petroleum Fund, established in July 2005. The budget's overarching theme is promoting economic growth as the key to fighting poverty, with significant infrastructure investment as the main mechanism to be employed. Submitted by the current government in August, it is nonetheless essentially the budget of former Prime Minister Mari Alkatiri and therefore reflects his priorities. However, Prime Minister Jose Ramos-Horta has taken on the anti-poverty emphasis as his own and his government added several items reflecting his own priorities. The key challenge for the budget will be the difficulties the GOET faces in executing its budgets. Last year's budget, at less than half the size, was only 70 percent executed, and this year's budget must be implemented in much less time. End summary.

Despite spirited debate, Parliament passed budget with few changes

12. The National Parliament passed the budget for FY 2006-2007 on August 14. Following final revisions, the President promulgated the budget in late August and it went into effect early this month. There was spirited Parliamentary debate over the budget.

Members of Parliament complained that it devoted insufficient resources to the needs for rebuilding, justice, and reconciliation created by the recent political and security crisis. However, they ultimately made only a few modest changes, all related to entitlements for Members of Parliament. Ramos-Horta required all ministers and vice ministers to be available for the duration of the Parliamentary debate, in sharp contrast to Alkatiri who was notoriously reluctant to make his

ministers available to be called by Parliament. All ministers will also be required this fiscal year to deliver monthly reports to Parliament on the work of their respective ministries.

Huge increases in spending underwritten by Petroleum Fund

13. The \$315.9 million budget for FY 2006-07 is more than double the size of last year's budget. It is also significantly higher than the budget of \$210 million budget that had been planned before the recent crisis. This significant increase is made possible by a transfer of \$260 million from the Petroleum Fund, the first use of the Fund to supplement the state budget since its establishment last year. The \$260 million Fund transfer is somewhat lower than the amount that could be withdrawn within GOET's previously announced guidelines for sustainable withdrawals from the Fund (\$283 million). Withdrawals on this scale have been made possible by the rapid growth of the Fund over the last year, which far outstripped early projections. As of the most recent quarterly report, dated June 30, the Fund stood at \$649.7 million, having grown from \$507.9 million the previous quarter. It is expected soon to exceed a billion dollars and will be the most significant source of budget growth for the foreseeable future.

Budget planning focus on poverty reduction

14. The Prime Minister and other GOET officials presented the budget's primary theme as poverty reduction, with increasing non-petroleum economic growth identified as the central strategy for addressing this. The budget narrative states a goal of between 7 and 8 percent annual growth by 2010. (Current non-petroleum growth is about 2 percent.) The main mechanism identified for achieving this is a massive increase in infrastructure investment (capital development spending), which has been increased from \$24 million in last year's budget to \$120 million this year. However, poverty reduction strategies

DILI 00000474 002.2 OF 003

have been integrated across the budget into all categories of spending, with particular emphasis on agriculture, health, education, and water and sanitation. The Government also announced its intention to spend substantially more in "the districts" (that is, outside the capital city) in an effort to combat the Dili-centered development trends of recent years.

Execution will be key challenge

15. Attaining the budget's anti-poverty goals will depend, of course, on effective budget execution, and many observers are skeptical about the Government's ability to succeed in implanting much of the 2006-2007 budget. A significant amount of each previous year's budget has been unexecuted. Last year the official execution rate was approximately 70 percent. However, this figure is calculated on the basis of "commitments", which earmark the money so that it is not lost at the end of the fiscal year but do not actually spend the money or even legally commit it. Thus the real execution rate last was far lower than the announced figure, and some money that was committed as long ago as FY 2003-2004 remains unspent.

16. Execution of this year's budget will be made more difficult by the fact that the largest increase in the budget is in capital development, traditionally the most difficult to spend because of the scope and complexity of GOET procurement processes. Also of concern is the short time during which the budget must be implemented. In addition to being promulgated two months after the beginning of the fiscal year, the budget is tied to the Ramos-Horta government's mandate which runs out on May 20, 2007, leaving less than nine months for its implementation.

17. The GOET has acknowledged the urgent need to improve budget execution. There is thus an effort underway to address key

structural issues underlying budget execution difficulties. These include an overly centralized decision-making structure and a procurement process that has previously required almost all spending to go through the underresourced and overburdened procurement office in the Ministry of Planning and Finance. The procurement law has already been changed to allow individual ministries to approve expenditures up to \$10,000 without going through the procurement office, but this change has not yet been fully implemented and will require extensive training on the new procedures before it can be.

Mostly Alkatiri's budget

18. The budget as passed is essentially the same budget as that submitted by the former government prior to Alkatiri's resignation. The overall budget strategy --- capital investment designed to create the infrastructure necessary for future growth --- was outlined in a major policy speech delivered by Alkatiri at the annual Timor-Leste Development Partners Meeting on April 4 (Ref B). Although there were accusations at the time that Alkatiri's anti-poverty drive was a politically cynical move in preparation for the 2007 elections, most international observers have evaluated the strategy itself positively.

19. There have, however, been substantive criticisms of some aspects of the budget. Critics have pointed out that the armed forces (F-FDTL), whose conduct during late April and May is generally regarded as among the principal causes of the political and security crisis, are being funded at a level of about twice that dedicated to the national police service (PNTL), which is also troubled but most of whose members are generally regarded as having behaved honorably during the crisis. Another focus of criticism is that the budget allocates the vast majority of funds for the 2007 elections to the Secretariat for Election Administration (STAE), which reports

SIPDIS

directly to the highly partisan Ministry for State Administration. The National Elections Commission (CNE) mandated by the Constitution requires to supervise the election process is funded only at about one-tenth the level of STAE.

DILI 00000474 003.2 OF 003

Some changes reflect Ramos-Horta's priorities

11. While the budget submitted by Ramos-Horta retained all elements of the original Alkatiri budget, it did include some additional items. The most significant single addition is a transfers and grants category, funded at \$18.2 million. This funding will be directly transferred to recipients, mostly in the districts, for projects related to education, agricultural development, health, crisis recovery, and civil society support.

Other additions in the Ramos-Horta budget include a 30 percent cost of living increase for civil servants, a \$7 million fund for rebuilding of homes destroyed during the recent unrest, additional funds for food security, and funds for the replacement of government property lost or stolen in recent months.

12. Comment: It is important to note the significant role the Petroleum Fund is playing in the budget. In Ref A, we expressed some concern that the Fund legislation left important loopholes that could allow GOET to draw down the Fund in excess of legislated limits. In light of the rapid growth of the fund, that now seems an unlikely risk for the foreseeable future. Rather, the amounts that GOET can withdraw within the set limits are so large in relation to the economy that they could contribute to the "resource curse" of overreliance on petroleum revenue leading to weak development in other areas of the economy. End comment.

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